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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Comments on the Exposure Draft, *Investment Entities*

To the Board Members:

The Japanese Institute of Certified Public Accountants (“we” and “our”) appreciates the continued efforts of the International Accounting Standard Board (IASB) on the consolidation project, and welcomes the opportunity to comment on the Exposure Draft (ED) on *Investment Entities*.

The following is our response to the items in 'invitation to comment' with which we disagree or have questions or concerns.

Question 1

Do you agree that there is a class of entities, commonly thought of as an investment entity in nature, that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

Comment:

We agree with the proposal, given that the IASB clarifies the cases where the measurement of investments at fair value through profit or loss can be considered

appropriate.

Since an entity that qualifies as an investment entity manages and evaluates its investees' performance on a fair value basis, even when it holds controlling interests in its investees, fair value information would provide the most useful information for its investments to both preparers and users of financial statements.

Based on this perspective, we support that the IASB's proposal will ensure that the actual state of investment activities of an investment entity (as defined) will be faithfully reflected in financial statements. However, given that IFRSs are principles-based set of standards, we believe that the IASB needs to clarify the basis of application of the cases, when it would be considered appropriate to measure investments at fair value.

Question 2

Do you agree that the criteria in this exposure draft are appropriate to identify entities that should be required to measure their investments in controlled entities at fair value through profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?

Comment:

We do not agree with the proposal. The definition of an investment entity needs to be amended or further clarified.

It is proposed in the ED that, to qualify as an investment entity, an entity will have to meet certain strict criteria. From the perspective of allowing an investment entity to be exempt from the consolidation requirements, we agree to set strict criteria in order to qualify as an investment entity. However, to enhance the application in practice, some criteria stated in paragraph 2 of the draft standard need to be further clarified, as follows:

(1) *Nature of the investment activity* (Paragraph 2 (a))

It should be clarified that certain investment activities, that are not substantially aimed to earn strategic operating return, will also be considered to meet this criterion, in nature of the investment activity. For instance, when an entity takes part in the private equity securities business by dispatching its executives only to earn capital appreciation, or when an entity takes part in the day-to-day management of the investees for the purpose of restructuring but its exit strategies by sales of the investees' assets are clearly determined, there may be cases when these entities can

qualify as investment entities. However, under the proposed definition, these entities will not be considered to meet the criteria for an investment entity.

(2) *Business purpose* (Paragraph 2 (b))

Paragraph B11 states that exit strategies can vary by type of investment, and mainly refers to the exit through disposal of assets as examples of those strategies. In regards to this, we request that it should refer to whether those exit strategies include investments only to earn investment income through investee's operation, not through disposal of assets. In addition, for a case when an investment entity holds multiple investments in its portfolio, we request the IASB to clarify as to whether those exit strategies should be applied to the selling of all or a part of the portfolio, or whether it would be applied only to the sales of individual assets within the portfolio.

(3) *Fair value management* (Paragraph 2 (e))

Paragraph B17 requires that investments of an investment entity shall be managed, and their performance evaluated, internally and externally, on a fair value basis. As to this requirement, we suggest to insert a sentence, describing how often an investment entity is expected to evaluate their performance on a fair value basis.

Question 3

Should an entity still be eligible to qualify as an investment entity if it provides (or holds an investment in an entity that provides) services that relate to:

- (a) its own investment activities?
- (b) the investment activities of entities other than the reporting entity?

Why or why not?

Comment:

We believe that an entity will be eligible to qualify as an investment entity, if it provides services that relate only to “(a) its own investment activities.” An entity should not be qualified as an investment entity, if it provides services that relate to “(b) the investment activities of entities other than the reporting entity,” as it will not meet the criteria for “pooling of funds” or “unit ownership.”

Assuming that an entity operates investment advisory services, as a case applicable to the condition (b) above.

In general, an entity that operates investment advisory services provides professional investment management services, based on a discretionary investment management agreement not only to entities within a group but also to external entities. Furthermore, it usually provides investment management services to funds or partnerships established by third parties in order to develop or reconstruct certain business, or investment advisory and agency services to third party investors.

Assuming that an investment entity has equity interests in such investment advisory entity, it would certainly be difficult to specify, amongst all other investment related services provided by the investment advisory entity, the services that relate only to the investment activities of the investment entity. Similarly, when the investment advisory entity itself provides investment related services to the third party investors, in addition to its own investment activities as an investment entity, it would also be difficult to identify the investment income earned solely through its own investment activities.

Through the requirements under “pooling of funds” and “unit ownership,” an investment entity will be required to return their portion of investment income to its investors which hold pro rata shares of the net assets proportionately to their ownership units. When an investment advisory entity cannot differentiate its own investment income earned solely from its own investment activities, it can no longer meet the criteria for an investment entity. Therefore, we believe that the exceptions for an entity that still meets the requirement of “nature of the investment activity” should be limited only to the above in (a), and not in (b).

Question 4

- (a) Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not?
- (b) If yes, please describe any structures/examples that in your view should meet this criterion and how you would propose to address the concerns raised by the Board in paragraph BC16.

Comment:

We believe that an entity should be eligible to qualify as an investment entity even when there is only a single investor unrelated to the fund manager, for the following reason.

The requirement for “pooling of funds” assumes that, within a typical investment entity, there are significant external investors who are not involved in the management of the entity. In case of Master Fund, it normally conducts financing activities directly through a single or a several number of feeder funds. Similarly, in a case of Master-Feeder Fund structure, when Master Fund performs its investment activities by using capital raised indirectly from significant external investors through feeder funds, to acquire control or to have significant influence on the investees should not be considered as investment activities, but rather solely to earn capital appreciation or investment income, even though they have equity interests in investees. Under such structure, we believe that the existence of a single investor unrelated to the fund manager will not cause improper use of investment entity accounting. Therefore, we believe that such an entity should also be eligible to qualify as an investment entity.

Question 6

Do you agree that the parent of an investment entity that is not itself an investment entity should be required to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities? If not, why not and how would you propose to address the Board’s concerns?

Comment:

We do not agree with the proposal. Even if an ultimate parent of an investment entity is not an investment entity as defined, we believe that it should retain the fair value accounting of its investment entity subsidiary.

Under the proposed draft it is expected that, in many cases, an ultimate parent of an

investment entity will qualify as an investment entity. However, in practice, an ultimate parent could range from entities such as banks, securities companies, insurance companies, or business corporations, and they may not be eligible to qualify as investment entities in many cases. In most cases, an ultimate parent has clearly defined policies and business models for investment activities conducted by an investment entity subsidiary, separate from their other investment activities. We understand that the purpose of the proposed draft standard is to ensure that the business models of an investment entity will be appropriately reflected in financial statements. However, this requirement will not ensure reflection of the differences in the business models within the group of ultimate parent in its consolidated financial statements. In this way, the proposed treatment will not satisfy the purpose of the proposed draft standard, and also it will not achieve relevant accounting results.

The accounting based on entities' business models is also employed in IFRS 9, *Financial Instruments*, and there seems to be no grounds for denying such treatment. Furthermore, requiring the fair value accounting of an investment entity subsidiary to be reversed and consolidated at a non-investment-entity ultimate parent level will not bring benefits that would exceed costs to both preparers and users of financial statements. Therefore, we support the Financial Accounting Standards Board (FASB)'s proposal for a non-investment-entity ultimate parent of an investment entity to maintain fair value accounting of an investment entity subsidiary, as opposed to the IASB's proposal.

In addition, in cases of conglomerates, even if the ultimate parent does not fall into the category of an investment entity, when one of its operating segments (for instance, investment and finance segment) meets the criteria for an investment entity, financial reporting should require the use of the most appropriate method, to reflect the performance of that segment. To address the IASB's concerns, we believe that the improper use of the special accounting for an investment entity may be avoided if an entity clearly distinguishes a relevant segment from the other segments and it satisfies the criteria for an investment entity, as defined.

Question 7

- (a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements?
- (b) Do you agree with the proposed application guidance on information that could satisfy the disclosure objective? If not, why not and what would you propose instead?

Comment:

We mostly agree with the proposed application guidance on information that could satisfy the disclosure objective, stated in above (b), however, we have concerns relating to the following.

Requiring to disclose information described in paragraph B19, such as per-share information, purchase premiums, redemption fees as well as ratios of expenses and net investment income to average net assets, may possibly be complicated in practice. As mentioned in paragraph B20, since an investment entity does not have to apply such disclosure requirement if it would cause duplication of disclosures, we believe it should be clarified that the list in paragraph B19 is merely for providing some examples of disclosures, and they should not be interpreted as requirements.

Question 8

Do you agree with applying the proposals prospectively and the related proposed transition requirements? If not, why not? What transition requirements would you propose instead and why?

Comment:

We generally agree with applying the proposals prospectively and the related proposed transition requirement. However, we suggest the IASB to make appropriate amendments to the IFRS 1, *First-time Adoption of International Financial Reporting Standards*, for the first-time adopters of IFRSs.

Although the IASB's proposal to apply the requirements prospectively is consistent with transitional requirements of the relevant standards for consolidation, when considering their relevancy to each other, it is appropriate to set the same effective date, that is, to be effective for annual periods beginning on or after January 1, 2013. Furthermore, we suggest the IASB provide guidance on the timing when changes in accounting treatment

and resulting impact from the application of this draft standard should be recognised in “other comprehensive income.” In order to ensure that first-time adopters of IFRSs can also shift to this standard on an equally basis with the entities already adopting the IFRSs, we believe it is desirable to amend IFRS 1.

Question 9

- (a) Do you agree that IAS 28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft? If not, why not?
- (b) As an alternative, would you agree with an amendment to IAS 28 that would make the measurement exemption mandatory for investment entities as defined in the exposure draft and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds? Why or why not?

Comment:

We support the alternative proposal in (b). IASB should amend IAS 28, *Investments in Associates*, to make the measurement exemption mandatory for investment entities as defined in the ED, while making it voluntary for other venture capital organizations, mutual funds, unit trusts and similar entities.

To date, IASB has not amended the scope of the application of the equity method accounting. However, if we take business models into consideration, for entities such as venture capital organizations that have voluntarily applied fair value through profit or loss, there may be some types of investments that presentation at fair value will be more suitable, compared to using the equity method. Until the comprehensive discussion to amend the IAS28 becomes effective , we believe it is appropriate to maintain the current requirements in IAS 28.

Yours faithfully,

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Executive Board Member – Accounting Practice (IFRS)

The Japanese Institute of Certified Public Accountants